# The Law of Contract

Lecture 3
MGT 388

This lecture will cover what we mean by a breach of contract, and what remedies are available for someone who suffers a breach.

It will also look at frustration, misrepresentation and arbitration.

## Discharge of Contractual Obligations

1 Discharged by performance – applies to most contracts. Obligations are "strict", but some obs are qualified.

2 Discharge by agreement – need consideration or deed.

3 Discharge due to frustration of contract – contract cannot be completed due to some occurrence beyond the control of the parties – more on this later.

4 Discharge by breach – occurs where one party fails to perform as agreed.

> "Innocent" party has the right to claim damages; the contract itself remains in force. Repudiatory breach = innocent party also has the option to terminate the contract as to future obligations, or they can affirm the contract.

## What constitutes a repudiatory breach?

The type of term that has been broken determines whether the breach is repudiatory.

Three classes of terms – conditions, warranties and innominate terms.

1 Condition - Breach is a repudiatory breach and so other party can terminate regards future obligations (e.g. series of supplies). Tend to be the most important terms e.g. payment, or significant errors in measurements.

2 Warranty - is a minor term, the breach of which only gives rise to a claim for damages, but not the right to terminate the remainder of the contract. Insignificant errors in measurements. Packaging variances etc.

3 "Innominate term" - Right to terminate depends on nature of the event leading to the breach and the effect of the breach.

For example, the late delivery of a couple of parts out of thousands for an engineering project is not likely to be a repudiatory breach.

On the other hand, late delivery of a major part may well give rise to the right to terminate any remaining deliveries.

**Anticipatory breach** is where one party, before time for performance has arrived, indicates that they will not perform the contract as agreed or is clearly unable to do so. The innocent party is permitted to treat the contract as terminated immediately.

## The right to claim damages

Compensation - aim is to put party who suffers the breach back in the position they would have been in had the contract been performed as agreed.

A claimant can claim for the expectation interest generally means that the claimant will be compensated for the financial loss incurred – the expected financial benefit.

This would therefore include any profit which that party had expected to make.

The concept of punitive damages is extremely limited in contract law.

Can be difficult to assess level of damages, for example if a party has lost a chance, but court will find a way to reach a figure for damages.

Sometimes a claimant may wish to recover expenses which have been incurred, and effectively lost due to the breach. This is generally allowed, as long as no "double" compensation occurs Anglia TV Ltd v Reed (1972) – Reed withdrew in breach, court allowed recovery of reliance expenditure incurred before conclusion of the contract, because it was reasonably in the contemplation of the parties that the expenditure would be wasted in the event of a breach. Also, no way of proving what profits would have been.

**Limits on compensation**

A **causal link** must be established between the claimant's loss and the defendant's breach. Generally the question is one of fact, and is not usually a difficult issue in practice. The test is often referred to the "but for" test – "but for" the breach, the loss would not have resulted.

A claimant can only recover for losses which:

- occur naturally or as a result of the usual course of things after a breach of contract

  or

- which were in the reasonable contemplation of both of the parties at the time the contract was entered into.

The operation of the two limbs can be seen in Victoria Laundry (Windsor) Limited v Newman Industries Ltd (1949). (Late delivery of boiler). This case made it clear that the courts may distinguish between ordinary profits and exceptional profits (from a government order which was not mentioned) and encourages parties to disclose exceptional losses that may be suffered on breach prior to entering into the contract.

A claimant is under a duty to take all reasonable steps to **mitigate his loss** – he will be unable to recover that proportion of his loss attributable to his failure to mitigate. For example, if an engineer is employed for a 4 week period but is then "dismissed" after one week in breach of contract, he cannot sit back and claim damages for the other three weeks. He must attempt to get alternative work for the period, and potential damages are reduced accordingly.

The law of contract does not generally compensate a claimant for **disappointment or hurt feelings or distress** caused by the mere fact of a contract being breached. Example - Engineer unfairly dismissed in a particularly vindictive way.

There are however some notable exceptions to this general rule….

For example, where the predominant object of the contract is to obtain some mental satisfaction - contract for a holiday.

Expanded in Farley v Skinner (2001) A surveyor was asked to report on a house including whether noise could be a problem due to its proximity to Gatwick airport. The surveyor said noise was unlikely to be a problem and was found to be in breach of contract. The “predominant object of the contract” test was dispensed with, and it was held that it is enough if the term breached was one which both parties knew to be important – the contract as a whole did not need to be for some mental satisfaction. This was satisfied on the facts as the defendant had specifically asked the surveyor to report on noise. (Value of house unaffected).

A **liquidated damages clause** is one which genuinely attempts to quantify the loss that will result on breach and will therefore be enforceable.

A penalty clause, on the other hand, is one which is not a genuine estimate but which attempts to compel performance by imposing a penalty for non performance.

Penalty clauses are generally unenforceable, but the court has equitable jurisdiction to enforce the clause up to an amount equivalent to the loss incurred.

**Heads of Damage**

- Cost of replacement performance – i.e. putting it right. If you are called in to make good a job which has been done badly by another engineer, then your client could sue the previous engineer for the level your reasonable costs.

- Lost profits – George Mitchell v Finney Lock Seeds (1983). Defective seed – farmer could sue for cost of seed - £200, and loss of profits from sale of crops which never grew - £61,000.

- Damage to property – Parsons (Livestock) Ltd v Uttley Ingham Ltd (1978) – faulty storage hoppers resulted in contaminated food = dead pigs. Farmer could sue for value of pigs.

- Personal injury – Godley v Perry (1960) – boy injured when elastic on catapult snapped – could claim damages for personal injury suffered.

- Damages payable to customer – Godley v Perry again – retailer sued supplier who had to compensate for damages payable to boy.

- Damage to commercial reputation – Aerial Advertising v Batchelors Peas Ltd (1938) – advertising plane flew over Manchester in middle of a two minutes silence on Armistice Day. People boycotted Batchelors products leading to a fall in sales.

- Emotional distress – as above – Farley v Skinner allowed this where surveyor wrongly reported on effects of noise from night flights.

- Loss of pleasure - again, as we saw earlier, this can be awarded where the main purpose of the contract was pleasure, relaxation etc. Holiday cases.

## Other remedies

The most common claim is the **claim for a debt**. To claim the "price" (where one party has performed) of a contract, substantial performance is required.

**Specific performance** - equitable remedy – where subject matter is unique – eg. Where engineered a unique item for a client. Must sell to them.

**Injunctions** can be ordered by the court to prevent the breach of a negative stipulation in a contract, such as restraint of trade clauses.

## Frustration

Contract not completed due to some occurrence or situation which is brought about through no fault of their own. Impossibility and Illegality.

A good example of the doctrine can be found in the well-known case of Taylor v Caldwell (1863). A contract for the hire of a concert hall was held to be frustrated when, before performance had begun, the concert hall burnt down. No fault.

The modern position is set out in Davis Contractors Ltd v Fareham Urban District Council (1956)– house builder delayed – shortage of skilled labour – risk not unforeseeable so not frustration.

The required performance has become something which is either impossible or fundamentally different from what the parties agreed to in the contract.

Frustration of purpose - Krell v Henry – hire of flat to view Coronation of Edward VII frustrated when Coronation didn't take place (more paid for flat).

**Risk allocation** – Commerce likes certainty.

It is common practice for the parties to a commercial contract to allocate the risk of potentially frustrating events between them - the risk of the potentially frustrating event will fall where agreed. This is known as a force majeure clause (p19). Must be drafted to cover the situation, so often drafted very widely. In practice, can be the focus of much negotiation.

**Fault** - Another important aspect of frustration. A party cannot claim frustration if due to some breach of the contract by that party, or where the event is self-induced. Any element of choice…

## Consequences of frustration

Law Reform (Frustrated Contracts) Act 1943.

- Money payable in advance is recoverable
- Money due but not yet paid is not payable.
- Court has discretion to allow the recipient to retain or claim such proportion of that money as the court thinks is just.
- Where one party has in some way performed their side of the contract and has, by doing that, conferred some valuable benefit on the other party, the court has discretion to award the performing party such sum as it considers just.

## Improper Conduct

Three areas of law deal with improper conduct in the entering into of contracts

1. Misrepresentation
2. Duress & Economic Duress
3. Undue Influence

## Misrepresentation

One party makes a false statement to another party which induces that other party to enter into a contract.

False statement = is the statement substantially correct? If so, it is not false.

A statement can be made orally or in writing. Can include conduct. So if the vendor of a property fraudulently concealed dry rot on an inspection by the buyer – could be held to have misrepresented that the property did not suffer from dry rot.

Generally, silence does not amount to misrepresentation due to the principle of "buyer beware", although there are a few exceptions to this rule, such as where circumstances change since a previous representation was made.

Misrepresentation generally applies to statements of fact. Statements of opinion or belief or future intention are therefore not generally subject to the law of misrepresentation.

However, statements of opinion made by experts have also been held to be statements of fact, based on their special skill and knowledge of a particular area.

There are **various elements** involved in whether a statement induced the other party to enter into the contract or not.

- The representation must be **material**. This is something of a formality, and operates to exclude trivial misstatements.

- The statement must be **known** to the other party in order to be said to induce them into entering the contract.

- The maker of the statement must also intend that the statement will be relied upon, and it must actually be relied upon.

There are **three types of misrepresentation**: fraudulent, negligent and innocent.

- Fraudulent misrepresentation is based on the absence of an honest belief that the statement is true, whether made deliberately or recklessly. Due to the serious nature of fraud claims, the courts may require a higher burden of proof on the claimant.
- Negligent misrepresentation is where the maker believes the statement is true, but has been negligent in reaching that conclusion. There are two limbs to this.
    - Common law - the injured party could bring a claim [in tort] for negligent misstatement. The leading case here is Hedley Byrne & Co.

Ltd v Heller & Partners Ltd (1964) – inaccurate bank reference given on customer.

There must be a close relationship between the maker and recipient of the statement in order for a claim to be made; a duty of accuracy is not owed to the whole world. Could apply to engineer and client.

- Secondly, under s2(1) Misrepresentation Act 1967, a person is liable for negligent misrepresentation if they induce another person to enter into a contract with them.

  This does not require any kind of "special relationship" but it does require that a contract be entered into.

  This section has advantages over the common law in that once the statement has been shown to be false and that it induced the entering into of the contract, it is up to the maker of the statement to show that they had reasonable grounds for their belief in the truth of the statement.

- The final type of misrepresentation is innocent misrepresentation. This applies where the maker of the false statement can show that they had reasonable grounds for their belief in the truth of the statement.

## Duress and Economic Duress

### Duress

The common law doctrine of duress in contract law originally related to where a person enters into a contractual agreement as a result of violence or the threat of violence. Obviously this means that the party has not entered the contract by his own free will and thus runs counter to the notion of freedom of contract.

It is important to note that this violence or threat of violence must be unlawful. As such, in the case of Williams v Bailey (1866) the threat to report a person for forging a signature could not be duress as the potential prosecution would have been a lawful act.

So for example:

- In *Barton v Armstrong* (1976) the plaintiff threatened to kill the defendant if he did not sell his interest in the company they were both major shareholders in.
- In *Cummings v Ince* (1847), an elderly lady was told to sign over all her property or face not ever having a committal order to a mental asylum lifted.
- OPTIONAL - Whilst in the earlier case *Skeate v Beale* (1840), the court decided that a threat had been directed towards property did not constitute duress. The later case of *The Siboen and the Sibotre* (1976), found that serious threats that constituted burning a house or damaging expensive paintings should be considered as duress. Therefore, duress also covers threats to property in the most serious circumstances.

Economic Duress

Criticised for being somewhat narrow, the law on duress was extended by the courts to cover what is now known as economic duress.

Economic duress was established in ***North Ocean Shipping Co v Hyundai (The Atlantic Baron)*** where the builders of a tanker who were being paid in dollars insisted on an additional 10% payment to compensate them for the devaluation of the dollar. The owners, who at that time were negotiating a very lucrative contract for the charter of the tanker, replied to the ship builders that although they were under no obligation to make additional payments, they would do so "without prejudice" to their rights. Payments of various instalments were made at the increased rate and without protest. The Court held that the ship builder's threat to break the contract without any legal justification unless the owners increased their payments by 10% did amount to duress in the form of economic pressure and, accordingly, the agreement was a voidable contract

However, the mere fact that a party has agreed a contractual variation after the other side has threatened to break or otherwise vary the terms of the contract does not necessarily mean that the doctrine of economic duress will apply. Along with the issue of causation, two elements are required. Firstly, the threat or pressure must vitiate consent and secondly, the threat or pressure must be 'illegitimate.'

*i)* *Must vitiate consent*

Lord Scarman in Pau On v Lau Yiu Long
"There must be present some factor 'which could in law be regarded as a coercion of his will so as to vitiate his consent.' .... In determining whether there was a coercion of will such that there was no true consent, it is material to inquire whether:

- the person alleged to have been coerced did or did not protest;
- whether, at the time he was allegedly coerced into making the contract, he did or did not have an alternative course open to him such as an adequate legal remedy;
- whether he was independently advised;
- whether after entering the contract he took steps to avoid it.

*ii)* *Illegitimate threat/pressure*

"Illegitimate pressure must be distinguished from the rough and tumble of the pressures of normal commercial bargaining." (Dyson, J in DSND Subsea Ltd v Petroleum
Geo Services ASA).

In that case, Dyson stated that in deciding whether the pressure is illegitimate, the relevant factors include:
(a) Whether there has been an actual or threatened breach of contract;
(b) whether the person allegedly exerting the pressure has acted in good or bad faith;
(c) whether the victim had any realistic practical alternative but to submit to the pressure;
(d) whether the victim protested at the time; and
(e) whether he affirmed and sought to rely on the contract.

## Undue Influence

The equitable doctrine of undue influence allows the court to intervene where a relationship between two parties has been exploited by one part in order to gain an unfair advantage.

This exploitation can arise where there is an abuse of a particular confidence placed in a party or where that party is a position of dominance over the victim.

This inequity in power between the parties has the potential to vitiate one party's consent if they are unable to freely exercise their independent will

As such, where this position of trust or dominance is abused in order to coerce a party to enter into a contract, the court may find the presence of undue influence.

Undue influence plays a far larger role in probate law as regards the making of wills. However, it is applicable to contract law too.

For example, a boyfriend threatening to split up with his partner if she doesn't agree to sell her car so that they can go on holiday or a mother threatening to disown her daughter if she doesn't enter a contract to sell a property she inherited from a long, lost uncle.

The similarities to duress are noted but undue influence covers those situations which do not revolve around the threat of violence or economic loss.

The law identifies two classifications of undue influence: actual and presumed (BCCI v Aboody).

Class 1 – Actual undue influence

Here the claimant must show that there is:

- a relationship of trust or confidence between the victim and the wrongdoer, and
- that the pressure that the wrongdoer exerted led to the victim entering into a particular transaction.

Class 2A – Presumed undue influence

With a Class 2 category of undue influence the focus is on the nature of the relationship of the parties.

In some cases, as categorised by class 2A, a relationship exists which at law gives rise to an automatic presumption of a position of influence (i.e. doctor/patient, lawyer/client, parent/child).

This means that the law will presume there is a relationship of trust or confidence between the victim and the wrongdoer, and that the wrongdoer exerted pressure leading to the victim entering into a particular transaction.

Here it is up to the defendant to rebut these presumptions by showing that the other party entered into the contract of their own free will and were aware of the risks involved. For example, showing that they received independent legal advice before signing the contract might suffice.

Class 2B – Presumed undue influence

In other cases, a relationship may exist which does not fall within those given by category 2A but is nonetheless significant, such as that between cohabitees or between an employer/employee. Here if the claimant can show that the relationship was one whereby trust/confidence placed in wrongdoer the law will presume the person was unduly influenced to enter the contract unless the defendant can prove otherwise.

**Remedies for improper conduct**

In all three instances (misrepresentation, duress, and undue influence) the remedy is rescission which means that the innocent party (the claimant) may choose to terminate the contract if he or she wishes. Damages are also available either in addition or in lieu of rescission except for cases of innocent misrepresentation.

## Arbitration

Parties may decide to provide in the contract for what happens when things go wrong.

Often found in commercial agreements.

Common way to do this is to provide that the parties will go to arbitration.

Explain what this is – agree to submit themselves to an independent expert.

Need a method of choosing arbitrator – mutual agreement or third party to appoint.

Decision is generally binding subject to limited rights of appeal for things like failing to comply with the agreed procedure, or making an uncertain award.

If proceedings are issued, can get a stay (s9 of AA) until arbitration has been carried out.

The AA 1996 provides a framework to ensure:

- that disputes are resolved fairly,
- that parties should be able to agree how to resolve their disputes, and
- the court should not intervene other than in very limited circumstances.

Advantages of arbitration…

Arbitrator is an expert

Opt out of state system – speed, control and privacy.

Also, informal = maintains relationships rather than all or nothing

Usually cheaper, but still expensive due to expertise of arbitrator.